44

Sales of Business Property

The tax treatment of sales of business property is cluttered with rules that attempt to reduce capital gain opportunities. Although in recent years capital gains have not received favored tax treatment, other than the maximum tax ceiling of 28%, Section 1231 and the recapture provisions of Sections 1245 and 1250 still apply.

If gain on the sale of depreciable property is related to prior depreciation deductions, the gain is taxed as ordinary income under the recapture provisions of Section 1245 and Section 1250. The treatment of losses and gains related to changes in value is determined by Section 1231.

Sales of business property must be reported on Form 4797, which incorporates the computation requirements of Sections 1231, 1245, and 1250.

How the Sale of Business Property Is Taxed

The following checklist summarizes how sales of assets and property used in business are taxed.

Sales of—	*Tax treatment—*
Merchandise, stock in trade, etc.	Profits are taxable as ordinary income; losses are fully deductible. Sales of merchandise are reported on Schedule C if you are self-employed or Schedule F if you are a farmer.
Machinery, buildings, office equipment, fixtures, vans, trucks, and other business property subject to depreciation	If you sell at a gain, the gain is taxable as ordinary income to the extent depreciation is recaptured under ¶44.1. Any remaining gain may be treated as capital gain or ordinary income, depending on the Section 1231 computation at ¶44.8. Losses may be property subject to depreciation deductible as ordinary or capital losses under the rules of ¶44.8. Sales are reported on Form 4797. Depreciable business equipment subject to recapture is described as Section 1245 assets. Depreciable livestock are also Section 1245 assets. Depreciable realty is generally described as Section 1250 assets. Recapture provisions do not apply to realty placed in service after 1986 and subject to MACRS straight-line depreciation.
Land	If used in your business, capital gain or ordinary income may be realized under the rules of Section 1231; *see* ¶44.8. If land owned by your business is held for investment, gain or loss is subject to capital gain treatment. Schedule D is used to report the sale of capital assets.

¶44.1 Recapture of Depreciation on Sale of Property

On Form 4797, you report gain or loss on depreciable property. Gain realized on the sale of depreciable *personal property* is treated as ordinary income to the extent the gain is attributed to depreciation deductions that reduced basis. In other words, the depreciation deductions are “recaptured” as ordinary income. If gain exceeds the amount of depreciation subject to recapture, the excess may be capital gain under Section 1231; *see* ¶44.8.

Gain on the sale of real estate placed in service before 1987 may be subject to depreciation recapture as discussed in ¶44.2.

Personal property (Section 1245 property). Gain subject to recapture for Section 1245 property is limited to the lower of (1) the amount realized *less* adjusted basis; and (2) recomputed basis less the adjusted basis. Recomputed basis is adjusted basis increased by depreciation deductions allowed or allowable. Generally, the depreciation deduction taken into account for each year is the amount allowed or allowable, whichever is greater. However, for purposes of figuring what portion of the gain is treated as ordinary income under the recapture rules (but not for purposes of figuring gain or loss), the depreciation taken into account for any year will be the amount actually “allowed” on your prior returns under a proper depreciation method, rather than the amount “allowable,” if the allowed deduction is smaller and you can prove its amount.

The adjusted basis of personal property depreciable under ACRS, such as business equipment and machinery, is fixed as of the beginning of the year of disposition. However, property depreciated under MACRS is subject to the convention rules so that partial depreciation under the applicable convention is allowed in the year of sale; this year of sale depreciation reduces adjusted basis.

Where basis was reduced by an investment credit for property placed in service after 1982, the basis reduction is treated as a depreciation deduction when figuring recapture; *see* Form 4797.

EXAMPLE

In 1994, you placed in service equipment (five-year property) costing $10,000. In 1994 you deducted depreciation of $2,000 and in 1995 you deducted $3,200. In January 1996, you sell it for $6,000. The MACRS deduction allowed for 1996, the year of sale, is $960 (19.20% × $10,000 ÷ 2). The adjusted basis is $3,840 ($10,000 – $6,160 total depreciation). Recomputed basis is $10,000 ($3,840 + $6,160). The amount of recapture is the lower of—

1. $6,160, the recomputed basis of $10,000 *less* adjusted basis of $3,840; *and*
2. $2,160, the amount realized of $6,000 *less* adjusted basis of $3,840.

The lower amount of $2,160 is recaptured as ordinary income on Part III of Form 4797; *see* the sample worksheet on page 574.

Dispositions other than sales. Exchanges of property (¶6.1) and involuntary conversions (¶18.19) may result in recapture of depreciation. For distributions which are not sales, exchanges, or involuntary conversions, the amount of recapture is all depreciation claimed, but not in excess of the difference between fair market value at disposition or original cost, whichever is less, and adjusted basis.

¶44.2 Recapture on Depreciable Realty

There is no recapture of straight-line MACRS depreciation (¶42.13) for buildings placed in service after 1986.

Recapture may apply to Section 1250 realty placed in service before 1987. Section 1250 property includes buildings and structural components, *except* for elevators and escalators or other tangible property used as an integral part of manufacturing, production, or extraction, or of furnishing transportation, electrical energy, water, gas, sewage disposal services, or communications. Property may initially be Section 1250 property and then, on a change of use, become Section 1245 property (¶44.1). Such property may not be reconverted to Section 1250 property.

Depreciation claimed on realty during the years 1964 through 1969. Depreciation claimed during this period is not recaptured.

Depreciation claimed after 1969 for realty placed in service before 1981. For nonresidential realty, 100 percent of the depreciation claimed after 1969 in excess of straight-line recovery is subject to recapture, but not in excess of the actual gain.

For residential rental property, there is no recapture of excess depreciation (over straight-line) claimed after 1969 and before 1976. Real property is considered residential rental property if 80% or more of gross income is from dwelling units. One hundred percent of the excess depreciation claimed after 1975 is subject to recapture. Part III of Form 4797 is used to compute the amount of depreciation recapture that is to be reported as ordinary income.

Depreciation claimed on realty placed in service after 1980 and before 1987. For real property placed in service after 1980 and before 1987 that was subject to ACRS, adjusted basis for computing gain or loss is the adjusted basis at the start of the year reduced by the ACRS deduction allowed for the number of months the realty is in service in the year of disposition; *see* ¶42.16.

If the prescribed accelerated method is used to recover the cost of *nonresidential* property, all gain on the disposition of the realty is recaptured as ordinary income to the extent of recovery allowances previously taken. Thus, nonresidential realty will be treated in the same way as personal property (¶44.1) for purposes of recapture if the accelerated recovery allowance was claimed. If the straight-line method was elected, there is no recapture; all gain is capital gain subject to the netting rules of Section 1231; *see* ¶44.8.

If accelerated cost recovery is used for a nonresidential building and straight-line depreciation is used for a substantial improvement to that building which you are allowed to depreciate separately (¶42.16), all gain on a disposition of the entire building is treated as ordinary income to the extent of the accelerated cost recovery claimed; remaining gain is capital gain taxed under the rules for Section 1231 assets (¶44.8).

For *residential* real estate, gain is ordinary income to the extent the depreciation allowed under the prescribed accelerated method exceeds the recovery that would have been allowable if the straight-line method over the ACRS recovery period had been used. If the straight-line method was elected, there is no recapture. All gain is capital gain, subject to Section 1231 netting; *see* ¶44.8.

For low-income rental housing, the same rule as for residential realty applies except that recapture is phased out at the rate of one percentage point per month for property held at least 100 months, so that there is no recapture of cost recovery deductions for property held at least 200 months (16 years, 8 months).

¶44.3 Recapture of First-Year Expensing

On Form 4797, the first-year expensing deduction (Section 179) is treated as depreciation for purposes of recapture. When expensed property is sold or exchanged, gain is ordinary income to the extent of the first-year expense deduction plus ACRS or MACRS deductions, if any; *see* ¶44.1.

Expensing deductions are also subject to recapture if property placed in service after 1986 is not used more than 50% of the time for business in any year before the end of the recovery period. The amount recaptured is the excess of the first-year *expensing* deduction over the amount of depreciation that would have been claimed in prior years and in the recapture year without expensing.

Automobiles and other "listed property." If the more-than-50% business-use test for a business automobile or other "listed property" such as certain computers (*see* ¶42.10) is not met in a year after the auto or other "listed property" is placed in service and before the end of the recovery period, any first-year expensing deduction is subject to recapture on Form 4797; *see* the Example at ¶43.9.

Installment sale. If you sell property on the installment basis, the first-year expensing deduction claimed for the property in a prior year is recaptured in the year of sale on Form 4797. An installment sale does not defer recapture of the first-year deduction.

Form 4797 worksheet goes here. Leave at least 2 pica of white space above form and 1 pica below.

¶44.4 Leasehold Improvements

Leasehold improvements placed in service after 1986 are not subject to recapture. However, a disposition of leasehold improvements placed in service before 1987 may be subject to recapture. To determine the recaptured amount, the lease period for figuring what would have been the straight-line depreciation and for figuring the additional depreciation includes all periods for which the lease may be renewed, extended, or continued under an option, exercisable by the lessee. However, the inclusion of renewal periods may not extend the lease by more than two-thirds of the period that was the basis on which the actual depreciation was allowed.

Recapture on a disposition of an acquired lease is also determined by these renewal rules.

¶44.5 Gifts and Inheritances of Depreciable Property

Gifts and charitable donations of depreciable property may be affected by the recapture rules. On the gift of depreciable property, the ordinary income potential of the depreciation carries over into the hands of the donee. When the donee later sells the property at a profit, he or she will realize ordinary income to the extent described in ¶44.1. A person receiving a gift of low-income housing property includes in the holding period the period for which the donor held the property for purposes of applying the 200-month phaseout of recapture rule (¶44.2).

On the donation of depreciable property, the amount of the contribution deduction is reduced by the amount which would be taxed as ordinary income had the donor sold the equipment at its fair market value.

On the death of a decedent, the transfer of depreciable property to an heir through inheritance is not a taxable event for recapture purposes. The ordinary income potential does not carry over to the heir because his or her basis is usually fixed as of the date of the decedent's death.

Important: A gift of depreciable property subject to a mortgage may be taxed to the extent that the liability exceeds the basis of the property; *see* ¶14.6 and ¶31.16.

¶44.6 Involuntary Conversions and Tax-Free Exchanges

Involuntary conversions. Gain may be taxed as ordinary income in either of the following two cases: (1) You do not buy qualified replacement property; *or* (2) you buy a qualified replacement, but the cost of the replacement is less than the amount realized on the conversion; *see* ¶18.23. The amount taxable as ordinary income may not exceed the amount of gain that is normally taxed under involuntary conversion rules when the replacement cost is less than the amount realized on the conversion. Also, the amount of ordinary income is increased by the value of any nondepreciable property which is bought as qualified replacement property, such as the purchase of 80% or more of stock in a company that owns property similar to the converted property.

Tax-free exchanges. Ordinary income generally is not realized on a tax-free exchange or trade-in (unless some gain is taxed because the exchange is accompanied by "boot" (¶6.3) such as money). The ordinary income potential is assumed in the basis of the new property.

Distributions by a partnership to a partner. A distribution of depreciable property by a partnership to a partner does not result in ordinary income to the distributee at the time of the distribution. But the partner assumes the ordinary income potential of the depreciation deduction taken by the partnership on the property. When he or she later disposes of the property, ordinary income may be realized.

¶44.7 Installment Sale of Depreciable Property

If you report on an installment basis a profitable sale of depreciable property made before June 7, 1984, "recaptured" ordinary income is reported before any of the capital gain is reported. You do not allocate the profit element of each installment payment between ordinary income and capital gain. As installments are received, you report all of the ordinary income until that amount is exhausted.

For a sale after June 6, 1984, all recaptured ordinary income is fully taxable in the year of sale, without regard to the time of payment. However, this rule does not apply to installment sales made under a contract binding on March 22, 1984, and all times thereafter.

Recapture is figured on Form 4797.

¶44.8 Property Used in a Business (Section 1231 Assets)

Form 4797 is used to report the sale or exchange of Section 1231 assets. The following properties used in a business are considered "Section 1231 assets":

- Depreciable assets such as buildings, machinery, and other equipment held more than one year. Depreciable rental property fits in this category if held more than one year.
- Land (including growing crops and water rights underlying farmland) held more than one year.
- Timber, coal, or domestic iron ore subject to special capital gain treatment.
- Leaseholds held more than one year.
- An unharvested crop on farmlands, if the crop and land are sold, exchanged, or involuntarily converted at the same time and to the same person and the land has been held more than one year. Such property is not included here if you retain an option to reacquire the land.

- Cattle and horses held for draft, breeding, dairy, or sporting purposes for at least 24 months.
- Livestock (other than cattle and horses) held for draft, breeding, dairy, or sporting purposes for at least 12 months. Poultry is *not* treated as livestock for purposes of Section 1231.

CAUTION

Capital Gain or Ordinary Loss

Profitable sales and involuntary conversions of Section 1231 assets are generally taxed as capital gain, except for profits on equipment and real estate allocated to depreciation (¶44.1), and losses are deducted as ordinary loss. However, the exact tax result depends on the net profit and loss realized for all sales of such property made during the tax year. Under the netting rules explained below, the net result of these sales determines the tax treatment of each individual sale. In making the computation on Form 4797, you must also consider losses and gains from casualty, theft, and other involuntary conversions involving business and investment property held more than one year.

Section 1231 netting. On Form 4797, you combine all losses and gains, except gains allocated to depreciation recapture, from:

- Sale of Section 1231 assets (from the list at the beginning of this section).
- The involuntary conversion of Section 1231 assets and capital assets held long term for business or investment purposes. You include casualty and theft losses incurred on business or investment property held long term. However, there is an exception if losses exceed gains from casualties or thefts in one taxable year, as discussed in the next column.

Involuntary conversions of capital assets held for personal purposes are not subject to a Section 1231 computation but are subject to a separate computation; *see* ¶18.25.

For an explanation of the ordinary income treatment of gain attributed to depreciation, *see* ¶44.1.

Result of netting. A net gain on Section 1231 assets from Form 4797 is entered on Schedule D as a long-term capital gain unless the recapture rule discussed below for net ordinary losses applies. A net loss on Section 1231 assets is combined on Form 4797 with ordinary income from depreciation recapture (¶44.1) and with ordinary gains and losses from the sale of business property that does not qualify for Section 1231 netting.

Recapture of net ordinary losses. Net Section 1231 gain is not treated as capital gain but as ordinary income to the extent of net Section 1231 losses realized in the five most recent prior taxable years. Losses are recaptured in chronological order on Form 4797. Losses that have already been "recaptured" under this rule in prior years are not taken into account.

Installment sale. Gain realized on the installment sale of business or income-producing property held long term may be long-term gain one year and ordinary gain another year. Actual treatment in each year depends on the net result of all sales, including installment payments received in that year; also *see* ¶44.7.

EXAMPLES

1. You realize these 1996 gains and losses:

	Gain	*Loss*
Gain on sale of rental property held two years	$5,000	
Loss on sale of business assets held four years		$3,000
	$5,000	$3,000
Net gain treated as long-term capital gain	$2,000	

As your gain exceeded the loss, each sale is treated as a sale of a capital asset held for a long-term period. The net gain is included in Schedule D along with your other long-term gains and losses, if any. The effect of this treatment is to give you a $2,000 long-term capital gain unless you realized a net Section 1231 loss in 1991, 1992, 1993, 1994, or 1995.

2. Assume the same facts as above, but your gain on the sale of rental property was $2,500. Since the gain does not exceed the loss and a net loss of $500 was realized, all of the transactions are treated as dispositions of noncapital assets. The net result is an ordinary loss of $500.

Losses exceed gains from casualties or thefts. You must compute the net financial result from all involuntary conversions arising from fire, storm, or other casualty or theft of assets used in your business and capital assets held for business or income-producing purposes and held more than one year. The purpose of the computation is to determine whether these involuntary conversions enter into the above Section 1231 computation. If the net result is a gain, all of the assets enter into the Section 1231 computation. If the net result is a loss, then these assets do not enter into the computation; the losses are deducted separately as casualty losses, and the gains reported separately as ordinary income. If you incur only losses, the losses similarly do not enter into the Section 1231 computation.

EXAMPLE

You suffer an uninsured fire loss of $2,000 on business equipment and gain of $1,000 on other insured investment property damaged by a storm. All of the property was held more than one year. Because loss exceeds gain, neither transaction enters into a Section 1231 computation. The gain is reported as ordinary income and the loss is deducted as an ordinary loss. The effect is a net $1,000 loss deduction. If the figures were reversed, that is, if the gain were $2,000 and the loss $1,000, both assets would enter into the Section 1231 computation. If they are the only two transactions in the year, the net effect may be a net capital gain of $1,000. If only the fire loss occurred, the loss would be treated as a casualty loss and would not enter into the Section 1231 computation.

¶44.9 Sale of a Proprietorship

The sale of a sole proprietorship is not considered as the sale of a business unit but as sales of individual business assets. Each sale is reported separately on your tax return.

A purchase of a business involves the purchase of various individual business assets of the business. To force buyers and sellers to follow the same allocation rules, current law requires both the buyer and the seller to allocate the purchase price of a business among the transferred assets using a residual method formula. Allocations are based on the proportion of sales price to an asset's fair market value and they are made in a specific order set out on Form 8594.

¶44.10 Sale of Property Used for Business and Personal Purposes

One sale will be reported as two separate sales for tax purposes when you sell a car or any other equipment used for business and personal purposes, or a house used partly as a residence and partly as a place of business or to produce rent income.

You allocate the sales price and the basis of the property between the business portion and the personal portion. The allocation is based on use. For example, with a car, the allocation is based on mileage used in business and personal driving.

EXAMPLE

Two partners bought an airplane for about $54,000. They used approximately 75% of its flying time for personal flights and 25% for business flights. After using the plane for eight years, they sold it for about $35,000. Depreciation taken on the business part of the plane amounted to $13,000. The partners figured they incurred a loss of $6,000 on the sale. The IRS, allocating the proceeds and basis between business and personal use, claimed they realized a profit of $8,250 on the business part of the plane and a nondeductible loss of $14,250 on the personal part. The allocation was as follows:

	Partners' claim	*IRS Business (25%)*	*IRS Personal (75%)*
Original cost	$54,000	$13,500	$40,500
Depreciation	13,000	13,000	
Adjusted basis	41,000	500	40,500
Selling price	35,000	8,750	26,250
Gain (Nondeductible loss)	($6,000)	$ 8,250	($14,250)

The partners argued that the IRS could not split the sale into two separate sales. They sold only one airplane and therefore there was only one sale. A federal district court and appeals court disagreed and held that the IRS method of allocation is practical and fair.

Other references: Allocation on sale of a partly rented residence; *see* ¶29.10. Trade-in of car; *see* ¶43.8. Recapture of depreciation; *see* ¶44.1.

¶44.11 Should You Trade in Business Equipment?

The purchase of new business equipment is often partially financed by trading in old equipment. For tax purposes, a trade-in may not be a good decision. If the market value of the equipment is below its adjusted basis, it may be preferable to sell the equipment to realize an immediate deductible loss. You may not deduct a loss on a trade-in. However, if you do trade, the potential deduction reflected in the cost basis of the old equipment is not forfeited. The undepreciated basis of the old property becomes part of the basis of the new property and may be depreciated. Therefore, in deciding whether to trade or sell where a loss may be realized, determine whether you will get a greater tax reduction by taking an immediate loss on a sale or by claiming larger depreciation deductions.

If the fair market value of the old equipment exceeds its adjusted basis, you have a potential gain. To defer tax on this gain, you may want to trade the equipment in for new equipment. Your decision to sell or trade will generally be based on a comparison between (1) tax imposed on an immediate sale and larger depreciation deductions taken on the cost basis of the new property, and (2) the tax consequences of a trade-in in which the tax is deferred but reduced depreciation deductions are taken on a lower cost basis of the property. In making this comparison, you will have to estimate your future income and tax rates. Also pay attention to the possibility that gain on a sale may be taxed as ordinary income under the depreciation recapture rules; *see* ¶44.1.

The tax consequences of a trade-in may not be avoided by first selling the used property to the dealer who sells you the new property. The IRS will disregard the sale made to the same dealer from whom you purchase the new equipment. The two transactions will be treated as one trade-in.

When you trade in a car used partly for business and partly for pleasure, treat the deal as if you had exchanged and received two different types of assets: a personal asset and a business asset. Allocate part of the costs of the old and new car to your business use and part to your personal use. Figure the results on each part. Trade-in rules for a business auto are discussed at ¶43.8.

¶44.12 Corporate Liquidation

Liquidation of a corporation and distribution of its assets for your stock is generally subject to capital gain or loss treatment. For example, on a corporate liquidation, you receive property worth $10,000 from the corporation. Assume the basis of your shares, which you have held long term, is $6,000. You have realized a long-term gain of $4,000.

If you incur legal expenses in pressing payment of a claim, you treat the fee as a capital expense, according to the IRS. The Tax Court and an appeals court hold that the fee is deductible as an expense incurred to earn income; the deduction is subject to the 2% adjusted gross income (AGI) floor discussed at ¶19.1.

If you recover a judgment against the liquidator of a corporation for misuse of corporate funds, the judgment is considered part of the amount you received on liquidation and gives you capital gain, not ordinary income.

If you paid a corporate debt after liquidation, the payment reduces the gain realized on the corporate liquidation in the earlier year; thus, in effect, it is a capital loss.

If the corporation distributes liquidating payments over a period of years, gain is not reported until the distributions exceed the adjusted basis of your stock.